United States Court of Appeals

for the Second Circuit

BRIEF FOR APPELLEE

76-7083

ORIGINAL

United States Court of Appeals

For the Second Circuit

FREQUENCY ELECTRONICS, INC.,

Plaintiff-Appellee,

against

NATIONAL RADIO COMPANY, INC.,

Defendant,

and

LOUIS LERNER,

Defendant-Appellant.

Appeal from the United States District Court for the Southern District of New York

BRIEF FOR PLAINTIFF-APPELLEE, FREQUENCY ELECTRONICS, INC.

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APPEAL FROM THE UNITED STATES DISTRICT COURT FOR THE SOUTHERN DISTRICT OF NEW YORK

BRIEF FOR PLAINTIFF-APPELLEE, FREQUENCY ELECTRONICS, INC.

STATEMENT OF ISSUES PRESENTED FOR REVIEW.

1. Was the decision of the District Court clearly erroneous in holding defendant-appellant, LOUIS LERNER ("Lerner"), the dominant and control person of NATIONAL RADIO COMPANY, INC. ("National") liable in fraud to Plaintiff-

Appellee, FREQUENCY ELECTRONICS, INC. ("Frequency") for fraudulently misrepresenting that the key patent in National's sale of its Atomichron product line to Frequency was valid and being infringed by National's chief competitor when such patent was, in fact, void?

2. Was the decision of the District Court clearly erroneous in holding that Frequency had defenses of failure of consideration and breach of warranty of title to its note for $325,000.00 (the "$325,000.00 note") given as consideration for a void patent?

3. Was the decision of the District Court clearly erroneous in holding that Lerner, who knew of Frequency's defenses to the $325,000.00 note, was not a holder in due course?

4. Was the decision of the District Court clearly erroneous in cancelling the $325,000.00 note given for the void patent and awarding Frequency $42,000.00 representing the sum it had heretofore paid on the note?

5. Whether parol evidence may be considered on the issues of fraud in the inducement of the agreement between Frequency and National and failure of consideration irrespective of any clause in the agreement stating that the agreement supercedes all prior understandings and may not be modified except in writing?

6. Should this Court consider whether National's discharge in bankruptcy discharged Lerner (although the applicable statutes provide not) where such issue was not raised in the District Court, and not argued in Lerner's brief to this Court?

STATEMENT OF NATURE OF THE CASE

Plaintiff-Appellee, FREQUENCY ELECTRONICS, INC. ("Frequency") started an action in the New York State Supreme Court against Defendant-Appellant, LOUIS LERNER ("Lerner"). Frequency's complaint also named Defendant, NATIONAL RADIO COMPANY, INC. ("National"), but National was never served with process, and was subsequently adjudicated a bankrupt. Frequency alleged four causes of action all arising from National's sale to it pursuant to a written agreement of National's Atomichron product line. Lerner participated in the transaction, was the dominant and control person at National, and subsequently acquired two (2) promissory notes given by Frequency as consideration. The first cause of action, against National, sought rescission of the agreement, return of the purchase price, and damages as a result of fraud. The second cause of action sought damages against National for National's breach of a warranty of title to a certain patent (referred to throughout this brief as the "Zacharias Patent"). The third cause of action sought damages for fraud against Lerner. The fourth cause of action sought a declaration that one of the notes held by Lerner (referred throughout this brief as the "$325,000.00 note") be cancelled, and that Lerner be adjudged not entitled to enforce that note. (1-10)

Lerner removed the action to the United States District Court for the Southern District and counterclaimed to enforce the $325,000.00 note. (64-65)

On May 16, 1972, Judge MacMahon granted Frequency a preliminary injunction enjoining Lerner from transferring or enforcing the $325,000.00 note pending the outcome of the action. The court held that Frequency demonstrated a substantial likelihood of success in establishing its defense to the note of failure of consideration since it appeared that the Zacharias patent was void. (Subsequently, Lerner conceded for all purposes in this action that the Zacharias patent was void) Further, plaintiff had raised serious doubts about Lerner's status as a holder in due course since Lerner, as National's principal figure, was chargeable with knowledge that the patent was void at the time he acquired the note. (50-59; 342 F. Supp. 1159)

By decision filed December 9, 1975 (Brieant, J.), the court below granted Frequency judgment: (a) declaring the $325,000.00 note cancelled, and (b) ordering rescission of that portion of the transaction relating to the $325,000.00 note as against Lerner and requiring him to pay damages of $42,000.00 (representing the amount Frequency had paid on the note) to Frequency, and upon such payment, requiring Fre-

quency to assign to Lerner the patents and data for which the note was given. The following summarizes the decision of the court below:

After noting that Lerner had stipulated that the Zacharias patent was void at the time Frequency acquired the Atomichron product line, the court held that Frequency had a good defense of failure of consideration to the $325,000.00 note because the note was given for a void patent. (91) Frequency also had a defense of breach of warranty since National had warranted title to the Zacharias patent, and National could not have had any title to a void patent. (92)

Lerner was not a holder in due course. He was a participant in the events surrounding the Zacharias patent and development of the Atomichron and National's dominant and control person. He knew or had reason to know of Frequency's defenses (93-94)

Lerner defrauded Frequency by misrepresenting that National had a strong patent position in the Atomichron and that a National competitor was infringing the Zacharias patent. The court below, applying Massachusetts law which governed the transaction, held no fraudulent intent need be shown nor any justifiable reliance. (98-100)

Frequency was damaged since the Zacharias patent was the key to the transaction; without it the remainder of

the consideration from National was worthless. The parties allocated $325,000.00 as the consideration for "patents and data". Consequently, since the fraud related only to patents, the $325,000.00 note (relating to patents) should be cancelled, Lerner should pay $42,000.00 to Frequency, and Frequency should assign all patents to Lerner. (100-102)

FACTS

By agreement (the "agreement") dated February 3, 1969, Frequency purchased National's Atomichron product line for $733,000.00 in cash and notes (12-35). A certain patent (Number 2,970,115) for a "molecular beam apparatus" invented by J. R. Zacharias and others (the "Zacharias patent"), and assigned to Frequency pursuant to the agreement, was central to the Atomichron (97). The Zacharias patent was void. National obtained it by fraudulently misrepresenting to the United States Patent Office that the invention had not been in public use, offered for sale or sold more than one year before the date of the patent application. (463-70; 683-87) Lerner, the dominant and control person at National, as its largest stockholder, National's treasurer, Chairman of the Board of Directors and Chairman of the Executive Committee since the development of the Atomichron and through the commencement of the within action (72, 123-24) participated in the fraud on the Patent Office or knew the facts which made the patent void at the time he negotiated with Frequency. Nonetheless, Lerner and others at National fraudulently represented to Frequency that the patent was valid and there was a cause of action for its infringement against National's competitor Hewlett Packard

Corporation. (134-137, 155-156) Lerner subsequently acquired the two notes given by Frequency as part of the consideration for the agreement. (453, 511) Upon discovery of the fraud, Frequency commenced the within action.

While this action was pending, Lerner conceded that the Zacharias patent was void. (74)

Frequency manufactures electronic components for communications, navigation and guidance systems. (126)

National manufactured the "Atomichron," or atomic clock, the most accurate instrument ever devised for measuring time.

Lerner, as the court below found, was the dominant and control person in National's affairs. (93) Since at least 1955, Lerner has been National's principal stockholder, owning 35-38% of National's outstanding common stock. (72) Both when the Atomichron was first developed in the 1950's and when negotiations between National and Frequency occurred and the agreement was signed in 1968 and 1969, Lerner was Chairman of National's Board of Directors, Chairman of the Executive Committee, and National's Treasurer. (72, 123-124) Lerner also acted as National's President for a time in early 1969. (361, 619) Lerner actively participated in all National's affairs, including the development of the Atomichron. (355) Lerner personally

participated in negotiations with Frequency, as further described below. Lerner had to approve all National's decisions, including the Agreement with Frequency. (41, 507) In any controversy with another National officer, Lerner would prevail. (619-620) In short, Lerner controlled National.

The Atomichron was developed in the 1950's by Zacharias, a National employee. National obtained the Zacharias patent through a fraud perpetrated on the United States Patent Office. On October 3, 1956, more than one year before the filing date of the Zacharias application, National held a press conference to demonstrate that Atomichrons containing the Zacharias invention were available for commercial and military use, and offered them for sale. Also, more than one year before the filing date, National sold at least six Atomichrons incorporating the Zacharias invention. (683-85; 469-70) Nonetheless, Zacharias and his co-inventors signed affidavits annexed to the Zacharias application swearing that the invention was not:

> "in public use or on sale in the United States for more than one year prior to this application." (463-465)

Then National's attorneys, in response to a Patent Office query as to whether the invention had been in commercial use or sold more than one year before the filing date, responded that it had not. (466-468; 686-687)

Lerner has stipulated that the Zacharias patent is void:

> " . . . the so-called Zacharias patent was invalid at the time of the sale of the Atomichron Product Line by National to Frequency on February 3, 1969, because the invention described in the so-called Zacharias patent was incorporated in the Atomichron offered for sale at the October 3, 1956 press conference conducted by National at the Overseas Press Club, 35 East 39th Street, New York, New York, and in the Atomichrons sold more than one year prior to October 29, 1957, the filing date of the patent application which resulted in the so-called Zacharias patent." (74)

Lerner participated in the fraud upon the Patent Office, knew about it, or is charged with such knowledge. Lerner was present at the October 3, 1956 press conference. (72) Lerner admitted that he knew as early as 1956 that the Zacharias Patent was essential to the Atomichron. (375-376) Lerner testified that at the time Zacharias was developing the Atomichron, he participated in such development as a member of National's Board of Directors, had conversations with Zacharias, and heard reports from him. During the course of this testimony, the following colloquy occurred:

> "THE COURT: . . . as far as I am

concerned, he is the biggest shareholder and he is treasurer, and he is a director. I assume he conducts his affairs in a business-like fashion, and whatever they were doing, he was in on it. I don't think there is anyone that disputes that.

That's true, isn't it?

THE WITNESS: [Lerner] Very true." (356-357)

There is a compelling inference that Lerner knew when the Atomichrons incorporating the Zacharias invention were sold and when the Zacharias application was filed. Thus, there is a strong inference that Lerner participated in the fraud on the patent office. The position taken by Lerner, that neither he nor National knew the Zacharias patent was void when negotiations with Frequency began is unbelievable. National took no steps to stop Hewlett Packard from infringing the Zacharias patent during the years before the Frequency transaction, and offered only the weakest excuse for such inaction--personnel problems (134-137). Had National possessed a valid Zacharias patent, it would have let nothing stand in the way of enforcing it.

The first meeting of Frequency and National occurred in May, 1968 in Atlantic City, New Jersey at an industry symposium. Martin Bloch, Frequency's President, was familiar with an atomic clock, exhibited at the symposium, which was

manufactured and sold by a National competitor, Hewlett Packard Corporation. Bloch noticed that the Hewlett Packard clock contained the invention that was covered by the Zacharias patent. (130) Consequently, he asked National's representatives why Hewlett Packard was being allowed to infringe the Zacharias patent. In response, National represented to Bloch that it had a strong patent position, and that action was being taken against Hewlett Packard to stop such infringement. (129-131)

Bloch had several meetings with Lerner. Lerner represented that National had a strong patent position with respect to the Atomichron. Only National's personnel problems had prevented National from stopping Hewlett Packard's infringement, stated Lerner. (134-137) However, Lerner represented that National had begun action to stop Hewlett Packard. As part of their transaction, Frequency could continue this action, but would share the proceeds with National. (148)

Bloch requested National's file on the Zacharias patent, and when it was not produced, telephoned Lerner and told him he felt leary about National's patent position. (155) As a result Lerner or another National officer in Lerner's presence gave Bloch a memorandum dated November 14, 1968 prepared by National's patent attorneys. (156) As found by the Court below, this memorandum represented that the Zacharias

patent was valid and that Hewlett Packard was infringing it. (95; the memorandum is reproduced at pages 456-462 of the Appendix)

The undisputed testimony showed, and the Court below found as a fact, that the invention covered by the Zacharias patent is absolutely essential to the successful commercial exploitation of the atomic clock and that it had been used in every version of the clock ever marketed. (97) As described above, Lerner admitted he understood the importance of the Zacharias patent. Bloch testified that everyone (including those at National) knew the Zacharias patent was the key to the transaction. Bloch also testified that he told Lerner and others this fact. Bloch also told them that it was important for Frequency to be able to stop Hewlett Packard from infringing or to collect royalties from them. (130, 235-36)

The November 14, 1968 memorandum was the "bait" prepared by National to "catch" Frequency. Lerner now pretends innocence both for himself and other National officers. However, when Lerner later acquired the Frequency notes from National, he acknowledged a letter from National which stated, in part:

> ". . . you [Lerner] effected the transaction <u>with full knowledge of the facts involved</u>"(512-513; emphasis supplied)

What "facts" could they have been referring to except that Frequency was knowingly sold a void patent.

Frequency relied on the November 14, 1968 memorandum and National's and Lerner's representations in deciding to purchase the Atomichron product line from National. Without the protection that the Zacharias patent gave, Frequency would in no way be able to compete with Hewlett Packard in manufacturing an atomic clock. (159-160)

The court below found that Lerner was unable to deny Bloch's testimony concerning statements made by him referring to the Zacharias patent. (95) Lerner testified: (1) he "might have" discussed patents with Bloch and that the discussion. . ."may have" referred to the Zacharias patent which I knew existed. . ."; (374-75) (2) Bloch "might have" said that he had to satisfy himself of National's strong patent position; (370) and (3) Lerner "might have" discussed why National had done nothing against Hewlett Packard. (371)

Furthermore, Lerner's testimony was vague and liberally sprinkled with "I don't recalls". (See e.g. 370, 372, 374) In fact the court below questioned Lerner's credibility after he testified that he did not remember where he lived in 1972. (316-318)

On February 3, 1969, Frequency and National signed the agreement. National warranted in Paragraph 5 that it had

full legal title to the patents and other property conveyed. National, in Paragraph 8, assigned to Frequency any and all causes of action for patent infringement, but Frequency and National would share equally in any net proceeds of such litigation. (16) The court below held that it could infer from Paragraph 8 that National and Lerner (who admitted approving that paragraph, 372-73) stated there was an outstanding claim against Hewlett Packard for infringing the Zacharias patent. It held:

> ". . .[Paragraph 8] is some evidence that Frequency believed and understood at the time of the agreement that there was an outstanding claim for infringement of the Zacharias patent against Hewlett-Packard. The only discussion which Frequency ever had with National on the topic of possible patent infringement actions against third-parties concerned infringement of the Zacharias patent by the Hewlett-Packard atomic clock." (96)

The $733,000.00 purchase price was allocated as follows:

Inventory - $250,000.00;

Machines and Equipment - $158,000.00;

Data and Patents - $325,000.00 (Paragraph 3 (13))

That portion of the consideration representing data and patents was to be paid by a note in the sum of $325,000.00 (the $325,000.00 note) payable in ten equal annual installments beginning February 3, 1970. The remainder of the considera-

tion was allocated by a payment of $208,000.00 upon execution of the agreement; and $200,000.00 pursuant to a second promissory note ("the $200,000.00 note") on or before August 3, 1970.(Paragraph 4 and Exhibits "C" and "D" of the agreement (13, 28-31))

The agreement also provided that Frequency was to pay National a royalty based upon annual net sales of the Atomichron. Further, Frequency was to assume certain contractual obligations of National, including National's obligations under an agreement with J. R. Zacharias to pay royalties to him. (Paragraphs 6 and 7) (14-16)

On June 27, 1969, Frequency and National modified the agreement. National gave Frequency a $23,000.00 credit representing certain equipment it had not delivered to Frequency. Frequency's payment of $32,500.00 due February 3, 1970 under the $325,000.00 note was reduced to $30,000.00, and its next payment of $32,500.00 was reduced to $12,000.00. (504)

After executing the agreement, Frequency made a demand upon Hewlett Packard to cease infringing the Zacharias patent. (543) Hewlett Packard replied that the Zacharias patent was void because Atomichrons incorporating it were in public use and offered for sale at the October 3, 1956 press conference , and sold more than one year before the filing

date of the Zacharias application (532-33)

Lerner subsequently acquired the Frequency notes. In November, 1969, National borrowed $300,000.00 from the Middlesex Bank (the "Bank"), due March 6, 1970 and assigned the Frequency notes as collateral. (514) Lerner, in effect, guaranteed repayment.(517)

In March, 1970, the Bank renewed the loan, with Lerner again, in effect, guaranteeing repayment. (455)

In April, 1970, the Bank advanced an additional $80,000.00 to National.(516) Thereafter, to satisfy his guarantees, Lerner borrowed $400,000.00 from the Bank and paid off the National debt, then $350,000.00. He kept the balance of $50,000.00. (515)

During the entire period the Frequency notes stayed at the Bank first as collateral for the loans to National, and then as collateral for the loan to Lerner. When Lerner paid National's debt, National, by separate written assignments, assigned each Frequency note to Lerner. (453, 511))

Lerner testified that he paid $323,000.00 for the Frequency notes then worth a total of $472,000.00. (332)

On April 24, 1970, National wrote a letter confirming Lerner's purchase of the Frequency notes, which letter was acknowledged by Lerner, stating, in part:

> "This is to confirm a transaction which you [Lerner] undertook at [National's] request at a time when [National] needed both cash and the retirement of bank debt . . .
>
> [National] further agrees to indemnify you [Lerner] against, and will come in and defend any setoff or counterclaim made by [Frequency] against you or the holder of said notes in any action to realize thereon, if said setoff or counterclaim is based on any action of the company [National] . . .
>
> . . .[National] wishes to reiterate that this transaction was suggested by you in order to provide [National] with required cash and debt servicing; that the price suggested by [National] was fair and reasonable; and that you effected the transaction <u>with full knowledge of the facts involved</u>." (512-513; emphasis supplied)

Lerner testified that he purchased the notes at a time when National was in poor financial condition. (387) Since Lerner was National's largest stockholder, the purpose of his purchase of the Frequency notes at a time when National was in precarious financial condition was to protect his own investment and secure repayment of National's loan, as he had guaranteed.

After the assignment of the Frequency notes to Lerner, Frequency paid a total of $212,000.00, which was credited to Lerner.

POINT I.

LERNER IS LIABLE TO FREQUENCY FOR FRAUD.

National's and Lerner's fraud started with the misrepresentations made to the Patent Office that the Zacharias patent had not been in public use, offered for sale or sold more than one year before the filing of the Zacharias application.

When Frequency came along National saw its opportunity to rid itself of the Atomichron line which was worthless because, without a valid patent, competitors such as Hewlett Packard could not be prevented from competing.

National's failure to take any steps to stop Hewlett Packard indicates that National knew that the Zacharias patent was void and could not be used as a basis for action against Hewlett Packard.

Unfortunately for National, Frequency knew at the outset that Hewlett Packard was infringing the Zacharias patent (130) and sought assurances of National's patent position. As a result Lerner and other National officers, misrepresented that National had begun action to stop Hewlett Packard from infringing upon the Zacharias patent. Frequency sought further assurances of National's patent position. Lerner, or another National officer in Lerner's presence handed Bloch the November 14, 1968 memorandum from

National's patent attorney which, as held by the court below, represented that the Zacharias patent was valid and being infringed by Hewlett Packard. (95) The final representation was contained in the agreement itself. Paragraph 8 provides that National assigns any patent infringement causes of action to Frequency. As the court below found, the only discussion which Frequency ever had with National about patent infringement actions related to the Zacharias patent. (96) Consequently, Paragraph 8 represents that the Zacharias patent is valid, and Hewlett Packard is infringing it. As the court below further found, Paragraph 8 is some evidence that Frequency believed and understood at the time of the agreement that there was an outstanding claim for infringement of the Zacharias patent. (96)

The facts found by the court below on the issue of Lerner's fraud and the other issues raised in this appeal are amply supported by the testimony and other evidence. The lower court's findings of fact should not be overturned on appeal unless clearly erroneous. (Rule 52 F.R.C.P.)

Under Massachusetts law,[1] Lerner is liable for fraud.

---

1. The agreement provides that Massachusetts law applies (18).

The common law elements of fraud have been much modified in that jurisdiction. The common law elements of fraud are:

(a) a representation of a material fact;

(b) which is false, and

(c) made with intent to deceive or so recklessly as to be the equivalent of such intent;

(d) which the party defrauded justifiably relies upon;

(e) thereby sustaining damages[2].

Under Massachusetts law, the defrauded party need not prove (1) intent to deceive, or (2) that he justifiably relied upon the misrepresentation.

The element of fraudulent intent is satisfied by:

> ". . . proof of a statement made as of the party's own knowledge, which is false; provided the thing stated is not merely a matter of opinion, estimate, or judgment, but is susceptible of actual knowledge; and in such case it is not necessary to make any further proof of an actual intent to deceive."
> (Powell v. Rasmussen, 355 Mass. 117, 243 N.E.2d 167, 168 (1969))

Even an innocent misrepresentation made in good faith is actionable. (Yorke v. Taylor, 322 Mass. 368, 124 N.E.2d 912 (1955); Pietrazak v. McDermott, 341 Mass. 107, 167 N.E.2d 166 (1960))

2. See W. Prosser Law of Torts, Sections 100-105 (3rd Ed. 1964); Norton v. Curtis, 433 F.2d 779, 793 (3rd Cir. 1970)(Cited by the Court below(95)).

Then, the defrauded party need not have justifiably relied upon the misrepresentation. The recipient of a misrepresentation may rely upon it even though he could have ascertained the truth had he chosen to look for it. Snyder v. Sperry and Hutchinson Co., ______ Mass. ______ , 333 N.E. 2d 421 (1975); Yorke v. Taylor, 322 Mass. 368, 124 N.E. 2d 912; New England Acceptance Corp. v. American Manufacturers Mutual Insurance Co., 344 N.E. 2d 208 (Appeals Court of Mass. 1976).

All the elements of fraud were proved.

Lerner made representations that the Zacharias patent was valid and that there was a cause of action for infringement against Hewlett Packard.

These representations were material to the transaction as the court below found. (97) Bloch testified that the Zacharias patent was the key patent in the production of the Atomichron, and that he informed Lerner and the other National officers of that fact. He further testified that an atomic clock could not be manufactured without the Zacharias patent. To his knowledge, every atomic clock previously manufactured had used the invention contained in the Zacharias patent. Finally, he testified that Frequency could not compete with Hewlett Packard or any other competitor with respect to the

manufacture of atomic clocks unless Frequency had the exclusive right to the Zacharias patent.

The representations were false, as described earlier in this brief and as the court below found. (97)

The element of intent was satisfied because the representations were of facts susceptible of actual knowledge made of the party's own knowledge. (See Powell v. Rasmussen, supra, as quoted in this brief, p.21 .)

A statement susceptible of actual knowledge means one which a party may, by investigation, determine to be true or false. Lerner's representations were susceptible of actual knowledge. Lerner has stipulated that the Zacharias patent was void because the invention which was its subject was in public use, offered for sale, and sold more than one year before the filing date of the Zacharias application. There was no cause of action against Hewlett Packard for patent infringement, because the Zacharias patent was void.

There is no question about when these facts were susceptible of actual knowledge; they could have (and should have) been determined as early as the filing date of the Zacharias application because a condition precedent to the approval of any patent application is a showing that the invention being patented was not in public use, offered for sale, or sold more than one year before the filing date. (35

U.S.C., §102(b)) Thus, in the Zacharias application, Zacharias, and his co-inventors (who, admittedly, at the time were agents or employees of National (682-83)) filed affidavits stating, in part:

> ". . . we do not know and do not believe that this invention was ever. . . patented or described in any printed publication in any country before our invention or discovery thereof, or more than one year prior to this application or in public use or on sale in the United States for more than one year prior to this application. . . ." (463, 464, 465)

The Patent Office, while processing the Zacharias application, wrote National asking whether the invention was in public use or sold more than one year before the filing date. (466-467) National's attorneys replied it was not. (468)

Lerner was at the October 3, 1956 press conference. Thus, Lerner knew that at that time the Zacharias invention was in public use and offered for sale. Lerner admitted that in 1956 he knew that the Zacharias patent was central to the Atomichron. (376) Lerner participated in the development of the Atomichron and was regularly kept informed by Zacharias of the status of such development. Considering the importance of the Zacharias patent, there is a strong inference that Lerner knew that Atomichrons were sold more than one year before October 29, 1957, the date of the Zacharias application, and that he knew

when the Zacharias application was filed. Anyway, Lerner as National's control and dominant person is charged with knowledge of these facts. (My Bread Baking Co. v. Cumberland Farms, Inc. 353 Mass. 614, 233 N.E.2d 748 (1968); See, also, Frequency Electronics, Inc. v. National Radio Company, Inc., 342 F. Supp. 1159 per Judge MacMahon. (55)) Thus, Lerner's representations were made of his own knowledge.

Lerner argues that statements about the Zacharias patent's validity were statements of opinion. However, as shown in Harris v. Delco Products, Inc., 305 Mass. 362 (1940), cited by Lerner (Brief, pp. 44-45), a statement of opinion relates to something not susceptible of actual knowledge. Thus, in Harris, the statement was that a well to be sunk would produce fresh water. As the court pointed out, there was no way of ascertaining the truth of this representation except by doing the very work being contracted for.

Chatham Furnace Co. v. Moffatt, 142 Mass. 403 (1888)(cited by Lerner, Brief, p. 43), is consistent with our case. In Chatham Furnace, an inaccurate survey misrepresented the location of iron ore as being within defendant's property. An accurate survey would have shown the ore as outside defendant's property. Similarly, in our case at the time of Lerner's representations, he could actually have determined that the patent was void.

Massachusetts courts take an expansive view of what is a representation of fact. For example, in McMahon v. M & D

Builders, Inc., 360 Mass. 54 (1971), the defendant-builder of a house represented that the house contained only the best or first class building materials, that it was soundly constructed and built in a workmanlike manner. The court held that such statements were representations of fact rather than opinion.

A representation of title is considered a representation of fact, even though questions of law may enter into the determination of title. (Lyman v. Romboli, 293 Mass. 373, 199 N.E. 916 (1936)).

Similarly, in this case, a representation that the Zacharias patent was valid was a representation that National had title to the patent (because a party has no title to a void patent). (See p. 32 , infra.)

Lerner made express misrepresentations. But even an implied misrepresentation will form the basis for a fraud cause of action. (Robichaud v. Owens-Illinois Glass, 313 Mass. 583, 48 N.E.2d 672 (1943))

The next element of fraud is reliance. The court below held Frequency relied upon Lerner's representations. (99) Bloch testified to such reliance. (159-160) The importance Frequency ascribed to the Zacharias patent and the continued effort to be assured about it shows Frequency's reliance also.

As stated earlier, and as held by the court below (100) under Massachusetts law, Frequency need not show it was justified in relying on Lerner's representations. In Yorke v. Taylor, Mass. 368, 124 N.E.2d 912, 916 (1955), the court stated:

> " . . . it does not matter that plaintiff could have ascertained the truth here. The recipient in a business transaction of a fraudulent misrepresentation of fact is justified in relying on its truth, although he might have ascertained the falsity of the representation had he made an investigation."

In Yorke, defendant innocently misrepresented the assessed value of the real property which was the subject of the transaction. The court held plaintiff relied upon such representation in spite of the fact that plaintiff employed an attorney who investigated the assessment himself (without determining the truth). In Snyder v. Sperry & Hutchinson Co., ______Mass.______, 333 N.E. 2d 421 (1975), the seller of realty misrepresented the terms of a written lease in favor of a third party. In spite of the fact that the buyer could have independently checked the lease, the court held that the buyer was justified in relying on the seller's representations.

Bloch's supposed expertise about patents (claimed by Lerner to be relevant on the issue of reliance, Brief, p. [illegible]) would not have helped Frequency since the patent's invalidity resulted from National's activities before the patent was obtained which were not disclosed to Frequency.

A plaintiff in a fraud action need not show that the misrepresentations were the sole or even the predominant factor in inducing him to consummate the transaction. (Sandler v.

Elliott, 335 Mass. 576, 141 N.E.2d 367 (1957)

Finally, it should be noted that Lerner can be liable for fraud based upon the activities of other officers and employees of National. As stated by My Bread Baking Co. v. Cumberland Farms, Inc., 353 Mass. 614, 233 N.E.2d 748, 751 (1968):

> "A . . . person controlling a corporation and directing or participating actively in its operations may become subject to civil or criminal liability on principles of agency or of causation."

Lerner, as the dominant person in National, would, accordingly, be charged with liability based upon the representations made by other National officers and employees.

The final element of fraud, damages, was also shown (as described in this brief, infra, Point II).

<u>POINT II</u>.

<u>FREQUENCY WAS ENTITLED TO THE RESCISSION OF THAT PORTION OF THE TRANSACTION RELATING TO PATENTS AS AGAINST LERNER, AND WAS ENTITLED TO RECOVER $42,000.00 FROM LERNER.</u>

Having found Lerner liable for fraud, the Court below granted partial rescission to Frequency. The $260,000.00 balance due on the $325,000.00 note was cancelled. Lerner was ordered to pay $42,000.00 which was the amount Frequency had already paid on the $325,000.00 note, on condition that Frequency assign to Lerner the patents and data represented by the $325,000.00 note. (101-102)

The Court was justified in granting this relief. Rule 54(c) F.R.C.P. provides: ". . . every final judgment shall grant the relief to which the party in whose favor it is rendered is entitled, even if the party has not demanded such relief in his pleadings." Thus, a Federal Court may grant equitable relief, although only damages are sought, or grant damages where only equitable relief is sought. (<u>Blazer</u> v. <u>Black</u>, 196 F.2d 139 (10th Cir. 1952); <u>Publishers Association of New York City</u> v. <u>New York Newspaper Pressman's Union Number Two</u>, 246 F. Supp. 293 (S.D.N.Y. 1965)). Even when the basis for relief must be determined under State law, the form of relief is governed by Federal procedural law. (<u>Blazer</u> v. <u>Black</u>, <u>supra</u>)

In fraud actions, the court has great discretion in awarding damages. The defrauded party may be awarded his out-of-pocket loss or damages representing the benefit of his bargain. (Rice v. Price, 340 Mass. 502, 164 N.E.2d 891(1960); cited by the court below. (100))

The court below held that the Zacharias patent was a key element in the transaction (97). The court noted that Lerner had not provided evidence to counteract Frequency's proof that without the Zacharias patent, all the other patents and data were worthless. (101) Since the $325,000.00 note related only to data and patents, it did not matter that there was no allocation of that consideration between the Zacharias patent, the 18 other patents, and the data transferred. (See the opinion below, 101) If the other patents and data were worthless without the Zacharias patent, then cancellation of the $325,000.00 note and return to Frequency of what it had already paid on that note would compensate Frequency for the loss sustained. Even assuming (which we do not concede) that there was a necessity for allocating the consideration between the Zacharias patent and the other items transferred,that allocation is taken care of by the court's requirement that Frequency assign all the patents and data to Lerner. Assuming such patents and data have a value, Lerner will get their benefit as a credit against the sum he must pay Frequency.

It should be noted that the remedy of rescission is available against Lerner even though the agreement was between Frequency and National, since Lerner committed fraud in connection with the agreement. (Gordon v. Burr, 506 F.2d 1080 (2nd Cir. 1974); Cady v. Murphy, 113 F.2d 988, 991 (1st Cir. 1940)). Furthermore, Lerner received $212,000.00 from Frequency as payments on the Frequency notes.

The court below measured damages conservatively. There was ample undisputed evidence that without the Zacharias patent, the whole transaction was worthless to Frequency. Consequently, Frequency lost not merely the amount represented by the $325,000.00 note, but the remainder of the $733,000.00 consideration.

POINT III

FREQUENCY ESTABLISHED DEFENSES OF FAILURE OF CONSIDERATION AND BREACH OF WARRANTY.

In Paragraph 5 of the agreement, National expressly warranted that it had title to everything conveyed to Frequency.

National breached this warranty because it did not have title to the Zacharias patent. A patent holder does not have title to a void patent. (Kennedy v. Hazleton, 128 U.S. 667 (1888); Koehring Company v. National Automatic Tool Co., 257 F. Supp. 282, 289 (D. Ind. 1966); aff'd 385 F.2d 515 (7th Cir. 1967) Consequently, Frequency may assert a defense of breach of warranty.

Even in the absence of Paragraph 5, this defense is available to Frequency. The assignment of patents contained an implied warranty of title. The assignment states:

> "Whereas, National Radio Company, Inc., . . . has obtained, used, and is using certain patents which are registered with the United States Patent Office. . .
>
> . . . National Radio Company, Inc. hereby assigns to said Frequency Electronics, Inc., all right, title and interest in and to the patents and inventions claimed therein. . ." (33)

This form of assignment is sufficient to imply a warranty of patent title, notwithstanding use of so-called

"quit-claim" language. Two cases cited by Lerner support this proposition.

In Westinghouse Electric Manufacturing Co. v. Formica Insulation Co., 288 F. 330, (6th Cir. 1923) (Lerner Brief, Page 29), the Court states (in a portion of the opinion directly following the language quoted by Lerner in his brief) that a quit-claim assignment of a patent carries with it an implication of good title.

In All Steel Engines v. Taylor Engines, 88 F. Supp. 745, 747 (N.D. Calif. 1950) aff'd 192 F.2d 171 (9th Cir. 1951)(Lerner Brief, Page 29), the Court held that a sale of a patent right contains an implied warranty of title. In our case, of course, National sold the Zacharias patent to Frequency.

Furthermore, the assignment states that National "has obtained, used and is using certain patents which are registered with the United States Patent Office." Such language amounts to an implied warranty of title because patents issued by the patent office are valid until otherwise shown. (35 U.S.C. §282.)

Gilmore v. Aiken, 118 Mass. 94 (1875) cited by Lerner, p. 26 et seq., is distinguishable. There the defendants argued that their note in favor of plaintiff was without consideration because one patent plaintiff had assigned to

them had not been validly reissued by the patent office.

But the assignment was limited to:

> ". . . whatever extension, [of the patent] if any, may be granted. . . by the Commissioner of Patents. . ." (118 Mass. at 95, note (See Lerner's Brief, p. 51)(emphasis added)

In other words, the assignor did not warrant that the patent would be reissued. Since defendant's complaint was that the patent was not reissued, not that it was void when originally issued, the court rejected his defense.

The interpretation given by Lerner to the assignment is unbelievable. Frequency would not have paid $325,000.00 (the amount allocated to data and patents) for an assignment of only such title as National had.

Cases cited by Lerner which relate to quit-claim deeds of real estate are inapplicable. As stated in Westinghouse Electric Manufacturing Co. v. Formica Insulation Co., 288 F. 330, 333 (6th Cir. 1923)(again, in a part of the opinion not quoted by Lerner):

> "With real estate, a conveyance from the sovereign gives good title to the land, and so title to the grant and title to the land are inseparable; not so as to patents, for the grant of the monopoly is always defeasable, by third parties, and the title to the grant may be immaterial."

Frequency may assert the defense of failure of consideration.

A note given for a void patent is unenforceable for failure of consideration. (Nash v. Luli, 102 Mass. 60 (1869) (cited by the court below, 91); Pratt v. Paris Gas Light & Coke Co., 168 U.S. 255 (1897); Herzog v. Heyman, 151 N.Y. 587 (1896); See Stentor Electric Mfg. Co. v. Klaxon Co., 115 F. 2d 268 (3rd Cir. 1940), rev'd on other grounds, 313 U.S. 487 (1941)).

The Zacharias patent was a void patent. The holder was not entitled to its issuance because of the admitted failure to satisfy the requirement of 35 U.S.C. §102 (b), that there be no public use or sale of the invention more than one year before the date of the patent application. Thus, the Zacharias patent did not exist.

National could not have owned the Zacharias patent nor sold it to Frequency. As stated in Sears v. Leland, 145 Mass. 277 (1877), (Lerner Brief, p. 25):

> ". . . Where the subject of a contract has no existence, as where two parties contract as to the sale of a horse, which, without the knowledge of either is dead, the contract may be rescinded."

The Zacharias patent was a "dead horse".

Authorities Lerner cites which discuss warranties of patent usefulness, as opposed to warranties of title, are inapplicable. Usefulness depends on such things as whether the patent infringes another person's patent. Title, as described above, depends on whether the patent holder was en-

titled to the patent's issuance. Thus, Rosenberg, Patent Law Fundamentals, p. 272 (1975)(Lerner Brief, p. 29), is inapplicable. Rosenberg is talking about warranties of patent usefulness, as shown by this portion of what Lerner quotes:

> ". . . there is no implied warranty that the licensee or assignee will be able to exploit the invention covered by the claims of the licensed or assigned patent without infringing the claims of some other patent having claims which dominate those of the patents which are the subject of the license or assignment."

Nash v. Lull, 102 Mass. 60 (1869), (cited by the court below (91) and by Judge MacMahon, 342 F. Supp. 1159, 1161, n.3) shows the distinction made between void patents and invalid ones. In Nash, the holder of a note sued the maker. The maker's defense was that he gave the note as consideration for a patent license and the invention which was the subject of the patent had no practical value. The court affirmed judgment for the holder since the patent was valid. But, as the court stated, where a note is given for a void patent, there is no consideration. The court described a void patent as one issued for an invention which does not meet the statutory criteria for the issuance of a patent. The Zacharias patent, as already stated, is such a patent.

Lerner (brief, p. 26) has misread the Nash case. The case did not concern when warranties are implied in the transfer of patent rights.

The invalidity of the Zacharias patent went to the heart of the transaction. As found by the Court below:

> "There was undisputed testimony that the invention covered by the Zacharias patent is absolutely essential to the successful commercial exploitation of the atomic clock and that it has been used in every version of the clock ever marketed. For Frequency, the Zacharias patent and the existence of a claim against Hewlett Packard were key elements in the whole transaction. . ." (97)

Thus, the invalidity of the Zacharias patent amounts to failure of consideration. It does not matter that other consideration remains; where the consideration which failed goes to the essence of the contract or takes away its foundation, failure of consideration is established. (See DeAngelis v. Palladino, 318 Mass. 251, 61 N.E. 2d 117 (1945))

The principle argued by Lerner that a Court should not inquire into the adequacy of consideration has no applicability to this case. The Zacharias patent was the heart of the transaction; without it the right to manufacture Atomichrons was worthless.

Similarly, the doctrine of partial failure of consideration has no applicability. But, even assuming, without conceding, that there was only partial failure of considera-

tion, the consideration which failed related to the $325,000.00 note which Lerner seeks to enforce. As Lerner's brief states:

> "In the case of a partial failure of consideration, the general rule is that the contract will not be apportioned by the Court except where, on the terms of the contract, there are distinct and independent considerations going to distinct parts of the contract. 17 Am. Jur.2d 445." (Lerner Brief, p. 31)

Since, under the terms of the Agreement, the $325,000.00 note related solely to patents, the invalidity of the Zacharias patent results in a failure of consideration with respect to that note and the Court need not consider whether the inventory, machinery, equipment, and trademark of National for which separate consideration was given, have any value.

POINT IV

LERNER IS SUBJECT TO THE DEFENSES OF FAILURE OF CONSIDERATION AND BREACH OF WARRANTY.

Lerner is not a holder in due course. He has purchased notes given by Frequency as consideration for an agreement he negotiated and approved, which benefited him as National's principal stockholder more than anyone, and which he fraudulently induced Frequency to enter into. The central subject of the agreement, as Lerner knew, was the Zacharias patent. National obtained the patent through a fraud committed on the Patent Office. Lerner, as National's dominant person, knew, or was charged with knowledge, of this fraud.

When Lerner purchased the Frequency notes, National was in bad financial condition. As Lerner acknowledged: it was "a time when [National] needed both cash and the retirement of bank debt". (512) By arranging to pay National's bank debt, Lerner fulfilled his guarantee of National's obligation. All of the foregoing, as more fully described earlier in this Brief, shows that Lerner is not a holder in due course of the $325,000.00 note.

Since Frequency has established defenses to the notes, as the court below held, Lerner has the burden of

proving that he is a holder in due course. (92) (§3-307(3) UCC [Ch. 106, Mass. Laws]; Korzenik v. Supreme Radio Inc., 347 Mass. 309, 197 N.E.2d 702 (1964). Judge MacMahon, in his decision granting Frequency a preliminary injunction also noted that Lerner has this burden of proof. (56)(342 F. Supp. at 1161-62))

Lerner is wrong when he argues (Brief, p. 12) that the court below did not dispute that he was a holder or that he took the instrument for value and in good faith. The court, in fact, held to the contrary, disposing of Lerner's status by holding that Lerner had not proved he had no notice of Frequency's defense of failure of consideration (92-93)

Lerner had "notice" of Frequency's defenses.

Section 3-302 UCC (Ch. 106, Mass. Laws) provides:

> "(1) A holder in due course is a holder who takes the instrument (a) for value; and (b) in good faith; and (c) without notice that it is overdue or has been dishonored or of any defense against or claim to it on the part of any person."

Section 1-201(25) UCC (Ch. 106, Mass. Laws) provides:

> "A person has "notice" of a fact when (a) he has actual knowledge of it; or (b) he has received a notice or notification of it; or (c) from all the facts and circumstances known to him at the time in question he has reason to know that it exists."

Section 3-304(1) UCC (Ch. 106, Mass. Laws) provides:

> "The purchaser has notice of a claim or defense if . . . (b) the purchaser has

notice that the obligation of any
party is voidable in whole or in part. . ."

Lerner had actual knowledge of Frequency's defenses. Lerner was present at the 1956 press conference. Because of Lerner's undisputed active participation in the events surrounding the development of the Atomichron, there is a compelling inference that Lerner knew when the Atomichrons incorporating the Zacharias invention were sold and when the Zacharias application was filed. Lerner participated in the fraud perpetrated on Frequency. Lerner and National have admitted actual knowledge of Frequency's defenses. At the time he purchased Frequency's notes, Lerner acknowledged a letter from National stating that he "effected the transaction with full knowledge of the facts involved." (513) This statement must refer to the fraud perpetrated on the patent office and Frequency.

In addition, Lerner has reason to know (using the test of §1-201(25)(c) UCC) that defenses in favor of Frequency exist. Under the "reason to know" standard, actual knowledge is not required. (E.L. Von Gohren v. Pacific National Bank of Washington, 8 Wash. App. 245 505 P.2d 467 (1973)).

Massachusetts law is in accord. As stated in Industrial National Bank of Rhode Island v. Leo's Used Car Ex-

change, Inc., 362 Mass. 797, 801 (1973) (Quoted by Lerner, brief, p.14)

> ". . . negligence goes to the notice requirement of Section 3-302 (1)(c) as defined by Section 3-304, and Section 1-201 (25)."

If actual knowledge were required to establish notice, §1-201(25)(c) UCC would be superfluous, since §1-201(25)(a) sets forth an "actual knowledge" standard.

In fact, Lerner recognizes that the "reason-to-know" test is part of Massachusetts law (Brief, p.17)

Bowling Green, Inc. v. State Street Bank and Trust Co. 425 F.2d 81 (1st Cir. 1970)(cited by Lerner, brief, pp. 13-14) is not inconsistent. All Bowling Green says is that the Code "focuses on the actual knowledge of the individual . . . " -- not that there must always be actual knowledge. In spite of what Lerner argues, (Brief, p.12 et seq.), Massachusetts applies the "objective test" of 1-201(25) UCC to determine notice, not a subjective one based upon what Lerner was consciously aware of (Morgan Guaranty Trust Co. of New York v. Third National Bank of Hampden County, _____ F.2d _____ (1st Cir. January 20, 1976); 18 UCC Rep. 483, 486-488).

"Reason-to-know" was defined in E.L. Von Gohren v. Pacific National Bank of Washington, supra, 505 P.2d at 472:

> "The phrase, 'reason to know', is not defined in the code, but a useful explanation of the phrase appears in the comments to Section 9 of the Restatement (Second) of Agency, comment d at 46 (1958):
>
> A person has reason to know of a fact if he has information from which a person of ordinary intelligence, or of the superior intelligence which such person may have would infer that the fact in question exists or that there is such a substantial chance of its existence that, <u>if exercising reasonable care</u> with reference to the matter in question, his action would be predicated upon the assumption of its possible existence. (Italics ours)"

Lerner would have reason to know of Frequency's defenses as a result of his position at National, his participation in the events relating to the Atomichron, and the transaction with Frequency and from the manner and circumstances surrounding his purchase of the notes. (See, the opinion of the court below, 93-94).

In connection with determining notice, and the other issues relating to whether a holder is a holder in due course, Lerner's participation in the underlying transaction with Frequency is quite significant. In <u>Winter & Hirsch, Inc</u>. v. <u>Passarelli</u>, 122 Ill. App. 2nd 372, 259 N.E.2d 312(1970), the holder of a note had participated in the transaction which resulted in the notes being issued. The holder had loaned its transferor the money which was loaned to the maker of the note. The court held that the holder was not a

holder in due course because of its participation in the original transaction. Another court has stated:

> "The more the holder knows about the underlying transaction which is the source of the paper, the more he controls or participates in it, the less he fits the role of good-faith purchaser for value; and the less justification there is for, according to him, the protected status of holder in due course considered necessary for the free flow of paper in the commercial world." (Jones v. Approved Bank Credit Corp. 256 A2d 739, 742 (Sup. Ct. Del. 1969)

Determining whether a holder is a holder in due course is essentially a question of fact dependent upon the particular circumstances surrounding the transaction. As stated in Bowling Green, Inc. v. State Street Bank & Trust Co., 425 F.2d 81, 85 (1st Cir. 1970), (in a portion of the opinion omitted from the quotation used by Lerner in his brief, p.14):

> "Since the application of [definitions relating to holder in due course] turns so heavily on the facts of an individual case, rulings of a District Court under Sections 3-302(1)(b) and 3-302(1)(c) should never be reversed unless clearly erroneous." (425 F.2d at 85)

In our case, of course, the court below held Lerner not a holder in due course, and that ruling should not be disturbed.

The cases cited by Lerner in his brief on the issue of his holder-in-due-course status have no applicability.

Thus, in Bowling Green, Inc. v. State Street Bank & Trust Co., supra, the issue was whether a bank was the holder in due course of a check deposited there. The court noted that the expectation of those handling checks is that checks will be rapidly negotiated and collected. The equities consequently are different from those applying to notes. (425 F. 2d at 85) Of course, the Bank was unrelated to the transferor of the check, while Lerner was the principal figure at National, and the Bank had not been a participant in the transaction which resulted in the check's being drawn.

In Industrial National Bank of Rhode Island v. Leo's Used Car Exchange, Inc., 362 Mass. 797 (1973 (Lerner Brief, p. 14), again the subject of the action was a check, cashed by the holder-bank's teller. It was undisputed that the holder-bank had no notice or reason to know of any defense to the check, in contrast to our case, where Lerner had notice of Frequency's defenses. Furthermore, there is quite a difference between a bank teller and Lerner, the transferor's dominant individual.

Mid-Continent National Bank v. Bank of Independence, 16 UCC Rep. 1286 (Mo. Court of Appeals, 1975) (Lerner Brief, p. 17, n.2) shows that notice of a defense will be inferred from facts and circumstances the holder is aware of. Plain-

tiff-maker and defendant-holder were banks. The subject of the action was a cashier's check. The maker bank's defense was that its cashier's check was given in exchange for a personal check which was returned for insufficient funds. The holder-bank was held to have notice of such defense because its employee, Walker, accepted the cashier's check from a fellow employee, Ortega, to cover a shortage in Ortega's "drawer" with knowledge that Ortega had frequent shortages in her drawer and covered them by her own personal checks which were written against insufficient funds. In fact, Walker acquiesced in Ortega's previous conduct. So although Walker had no actual knowledge that the maker had a defense to its cashier's check, Walker had reason to know of such defense because of her knowledge of and acquiescence in Ortega's conduct in the past.

As the court stated in a part of the opinion quoted by Lerner (brief, p.17 n.2):

> ". . . actual knowledge may be inferred from the facts and circumstances surrounding acquisition of the instrument. . ."

Colin v. Central Penn National Bank, ___ F. Supp. _______ , 18 UCC Rep. 188 (E.D. Pa. 1975) (Lerner brief, p. 18, n.2) involved stolen negotiable debentures. The holder-bank acquired them as security for a loan. In Colin, the holder had no relationship with the original owner of the bonds; nor had the holder received any notice that the bonds

were stolen. In short, there were no facts and circumstances of which the holder was aware which would charge it with notice.

While it appears that Lerner's notice of Frequency's defenses disposes of the issue of whether he was a holder in due course, we wish to point out that Lerner did not prove "good faith". Lerner committed fraud which resulted in the issuance of the Frequency note, and Lerner participated in, knew about, or was chargeable with knowledge of the fraud committed in the Patent Office. Finally, Lerner's motive in purchasing the Frequency notes was to protect his investment in National and fulfill his guarantee of National's debt. As recited in Lerner's brief (p. 14), good faith is honesty in fact, and Lerner is distinctly not within that standard.

As quoted by Lerner, Brief, p. 18 n.2:

> "[A holder must inquire where his failure to do so] would indicate a deliberate desire on his part to evade knowledge because of a belief or fear that investigation would disclose a vice in the transaction." Colin v. Central Penn National Bank, ___ F. Supp. _____, 18 UCC Rep. 188, 194 (E.D. Pa. 1975). [Emphasis in original.]

No clearer case for the application of the above standard exists than our case.

Even assuming Lerner is a holder in due course,

(which Frequency does not concede) Lerner is still subject to Frequency's defenses. Section 3-305 UCC (Ch. 106, Mass. Laws) provides:

> "To the extent that a holder is a holder in due course, he takes the instrument free from . . .(2) all defenses of any party to the instrument with whom the holder has not dealt. . ." (emphasis supplied)

Frequency is a person with whom Lerner dealt. (Hall v. Westmoreland, Hall & Bryan, 123 Ga. App. 809, 182 S.E.2d 539 (1971); Brotherton v. McWaters, 438 P.2d 1 (Sup.Ct. Okla. 1968).

Finally, it appears that Lerner was not a holder of the note, so, of course, he could not have been a holder in due course. When the note was assigned to Lerner, the note was in the possession of the Middlesex Bank. The assignment was made by a separate document. No endorsement of the note was written on the note itself. There was no evidence that the assignment was permanently affixed to the note. Thus, under §3-302, UCC (Ch. 106, Mass. Laws) the note was not negotiated to Lerner, and, accordingly, Lerner did not become a holder of the note. That Section provides, in part:

> "(1) Negotiation is the transfer of an instrument in such form that the transferee becomes the holder. If the instrument is payable to order it is negotiated by delivery with any necessary endorsement; . . .

> (2) An endorsement must be written by or on behalf of the holder and on the instrument or on a paper so firmly affixed thereto as to become a part thereof."

So, at most, Lerner was an assignee subject to all defenses which could be asserted against National, his assignor. (Lerner alternatively argues that he is an assignee <u>without notice</u>, and wrongly states that the court below disposed of this point without specific findings of fact or conclusions of law. (Brief, p.23) The same factual findings which show Lerner was not a holder in due course show that he was not an assignee for value without notice.)

POINT V

THE COURT BELOW WAS ENTITLED TO CONSIDER EVIDENCE OF FRAUDULENT MISREPRESENTATIONS MADE BY NATIONAL AND LERNER IRRESPECTIVE OF ANY "PAROL EVIDENCE" CLAUSE IN THE AGREEMENT BETWEEN NATIONAL AND FREQUENCY.

The agreement contains the usual "parol evidence" clause providing that it supercedes all prior understandings of the parties and may not be modified or amended in any respect except in writing (Paragraph 15)(18). Nonetheless, the court below properly considered evidence outside the agreement. Fraud involved in a contract may be proved by extrinsic evidence notwithstanding the "parol evidence" rule. (Broomfield v. Kosow, 349 Mass. 749, 212 N.E.2d 556 (1965); Sandler v. Elliott, 335 Mass. 576, 141 N.E.2d 367 (1957). Thus, in Moran v. Levin, 318 Mass. 77, 64 N.E.2d 360 (1945), the contract which was the subject of the action provided that it constituted "the entire agreement. . . and the said cows [the subject of the contract] are now accepted without any express or implied warranty." Nonetheless, the court held that plaintiff could prove representations relating to the cows not contained in the contract. Section 2-202 UCC (Ch. 106, Mass. Laws) which Lerner relies upon (brief, pp. 35-6) has not changed the above rule. (City Dodge, Inc. v. Gardner, 232 Ga. 766, 208 S.E.2d 794 (1974))

Where fraud is claimed, the parol evidence is used to negate the contract, not contradict the terms of it. City Dodge, Inc. v. Gardner, supra.)

DePasquale v. Bradlee & McIntosh Co., 258 Mass. 483 (1927), which Lerner quotes (Brief, p. 40), is distinguishable, as set forth in the part of the opinion quoted by Lerner:

> "At trial there was no claim and no offer made to prove that the contracts introduced in evidence by the plaintiffs were executed by them by reason of any fraud or misstatement as to the nature of the instrument which they signed or of any fraud or misstatement as to the meaning of the contents of the executed memorandums."

Similarly, Frick Company v. New England Insulation Co., 347 Mass. 461, 467, 198 N.E.2d 433, 437 (1964) (Lerner Brief, p. 36) is distinguishable because there was no issue of fraud in the inducement, only breach of contract.

Similarly, failure of consideration may be shown by parol evidence. (See Tanners National Bank of Wolburn v. Dean, 283 Mass. 151, 186 N.E. 219 (1933); Maybury Shoe Co. v. Izenstadt, 320 Mass. 397, 69 N.E.2d 666 (1946)). Again, as with fraud, failure of consideration goes to the existence of the agreement; parol evidence is not being used to change or contradict terms of the agreement.

The warranty of title contained in the agreement (Paragraph 5) speaks for itself. No parol evidence was used in determining that there was a warranty of title and that as a result of the Zacharias patent being void, it was breached. (92)

POINT VI

NATIONAL'S DISCHARGE IN BANKRUPTCY DID NOT DISCHARGE LERNER.

Raised as an issue in Lerner's brief, but not otherwise discussed, is whether Lerner was discharged by National's adjudication as a bankrupt. Lerner was not discharged. 11 U.S.C. Section 34 provides:

> "The liability of a person who is a co-debtor with or guarantor or in any manner a surety for a bankrupt, shall not be altered by the discharge of such bankrupt."

11 U.S.C. Section 22b, provides:

> "The bankruptcy of a corporation shall not release its officers, the members of its board of directors. . . or its stockholders, from any liability under the laws of a state or of the United States."

Thus, the general rule is that discharge in bankruptcy affects only the personal liability of the debtor and not the liability of other persons. (1A Collier Bankruptcy, 14th Ed. Paragraph 16.02; E.S. Parks Shellac Co. v. Harris, 237 Mass. 312, 129 N.E. 617 (1921)

CONCLUSION

For the above stated reasons, the judgment of the Court below should be affirmed in all respects.

Respectfully submitted,

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Affidavit of Service by Mail

In re:

Frequency Electronics, Inc. v. National Radio Company, Inc. and Louis Lerner

State of New York
County of New York, ss.:

Harry Minott,

being duly sworn, deposes and says, that he is over 18 years of age. That on JUN 25 1976, 197..., he served 2 copies of the within Brief in the above named matter on the following counsel by enclosing said two copies in a securely sealed postpaid wrapper addressed as follows:

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~~and depositing same in the official depository under the exclusive care and custody of the United States Post Office Department within the City of New York.~~

and depositing same at the Post Office located at Howard and Lafayette Streets, New York, N. Y. 10013.

Harry Minott

Sworn to before me this 25th
day of June 1976

Jack A. Messina
JACK A. MESSINA
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